

**Analysis of Notice Error Trends May Identify
Systemic and Procedural Causes for
Erroneous Notices and Refunds**

June 2002

Reference Number: 2002-30-095

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DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

June 7, 2002

MEMORANDUM FOR COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION
COMMISSIONER, WAGE AND INVESTMENT DIVISION

David R. Gaudin

FROM: (for) Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Analysis of Notice Error Trends May Identify
Systemic and Procedural Causes for Erroneous Notices and
Refunds (Audit # 200130049)

The report presents the results of our review of notice error trend analysis. The overall objective of this review was to determine if the Internal Revenue Service (IRS) has been effective in identifying trends in erroneous refunds and notices for business taxpayers' accounts, in initiating corrective actions, and in determining additional steps that could be taken to make use of available information to identify systemic and procedural problems.

In summary, we found that no national trend analysis of the error rates reported by the Notice Review functions is performed to determine whether systemic problems exist that cause erroneous notices and/or refunds to generate. Such a review would provide the opportunity to identify process / business practice improvements as early in the process as possible, as called for by the IRS' Strategic Plan; in this case, such improvements could reduce taxpayer burden.

Further, although Problem Analysis System (PAS) analysts at IRS Campuses perform reviews of notices being issued to taxpayers to evaluate and improve the quality of notices, they do not include voided notices within the scope of their review. These types of notices, therefore, bypass measurement under the IRS' Balanced Measures of performance.

Management's Response: IRS Management has directed the PAS Units in the IRS Campuses that process business taxpayers' returns to perform monthly analyses of the notice error rates to identify trends, determine root causes, and propose solutions. The results of the analyses will be included in the Balanced Measures Report. They will also explore the feasibility of having the PAS Units conduct a review of voided notices on a 90-day test basis. The results will be submitted to Small Business/Self-Employed Division Headquarters for evaluation. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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Analysis of Notice Error Trends May Identify Systemic and Procedural Causes for Erroneous Notices and Refunds

Background

The Internal Revenue Service (IRS) sent over 14 million notices and \$37 billion in refunds to business taxpayers in Calendar Year (CY) 2000. Some of the notices and refunds scheduled to be sent to taxpayers are selected for review by the IRS Campuses'¹ Notice Review functions. Their selection is based on established criteria recently updated in a joint effort by the Notice Review functions at the IRS Campuses and the Small Business/Self-Employed (SB/SE) Division Headquarters.

The criteria are designed to select notices based on the potential for the notice to contain erroneous elements. For example, if a payment is received from the taxpayer after a notice of the balance due is printed, logically the notice does not reflect the payment. Notices are printed ten days prior to mailing. The Notice Review Program recognizes the payment, and selects the notice for review.

These reviews are conducted to improve both the accuracy and quality of information sent to taxpayers, as well as to prevent the issuance of erroneous refunds. Based on the review, the notices are mailed, corrected, or voided; and incorrect refunds may be stopped.

Currently, systemic or procedural problems identified by the Notice Review tax examiners or managers are reported to the functions where the errors occurred for correction. All error information is available on-line to SB/SE Division Headquarters analysts in the On Line Notice Review (OLNR) Notice Disposition Reports.²

Problem Analysis System (PAS) analysts at the IRS Campuses also perform reviews of notices being issued to

¹ The IRS Campuses, where returns are processed and issues with taxpayers' accounts are resolved, consist of Submission Processing, Accounts Management, and Compliance. The Notice Review function is part of Submission Processing.

² These reports record the volume of notices selected for review by the Notice Review Processing System (NRPS), the volume actually reviewed, and the number of notices retyped, labeled, or voided. The percentages of notices reviewed that were correct and incorrect for each type of Master File (the IRS' main computer system, containing taxpayer accounts) notice selected are also contained in the Notice Disposition Reports.

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evaluate and improve their quality. Their findings are reported to Wage and Investment (W&I) Division Headquarters by entering the results of their reviews on the Quality Review Data Base, and are also available to SB/SE Division Headquarters.

In May 2001, the Treasury Inspector General for Tax Administration (TIGTA) issued a report³ on the IRS' Notice Review Program. The TIGTA found that there was no national review of the data compiled to monitor and evaluate the Notice Review Program. The report stated that the IRS did not review all potentially erroneous notices, that the Notice Review functions at the IRS Campuses did not place priority on notices with the highest potential for error, and that the national oversight of the Notice Review Program could be improved. No recommendations were made at that time due to the transition of the Program into the IRS' new operating division structure. However, in October 2001, Cumulative Notice Disposition Reports for the 2 IRS Campuses transitioning to full-time Business Master File (BMF)⁴ submission processing indicated that over 80 percent of the BMF notices selected by NRPS were reviewed by the Notice Review function.

We performed this audit at the IRS SB/SE and W&I Divisions' Headquarters and at the Submission Processing Centers at the Brookhaven, Cincinnati, and Ogden IRS Campuses from August through December 2001. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

³ *Management Advisory Report: The Notice Review Program Should Be Improved To Prevent Erroneous Notices From Being Sent To Taxpayers* (Reference Number 2001-40-078, dated May 2001).

⁴ The BMF contains the accounts of business taxpayers, while the Individual Master File (IMF) contains the accounts of individual taxpayers.

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The Internal Revenue Service Does Not Analyze Notice Error Rates to Effectively Identify the Root Cause of Error Trends

In response to criticisms for not meeting customers' expectations with respect to providing accurate account information, processing tax returns timely, and resolving accounts quickly, the IRS' Strategic Plan for Fiscal Years 2000-2005 called for the reduction of taxpayer burden. This was to be accomplished by improving the IRS' business practices as early in the process as possible, and by preventing problems rather than addressing them well after returns are filed, accounts adjusted and taxpayers notified.

During CY 2000 and 2001, the Notice Disposition Reports for 3 IRS Campuses reported that at least 32 percent of reviewed BMF notices meeting selection criteria had to be corrected or voided. The 2 IRS Campuses transitioning to full-time BMF submission processing stopped over 11,000 BMF refunds totaling more than \$132 million during CY 2000. These same sites stopped over 12,000 BMF refunds totaling more than \$316 million in just the first 10 months of CY 2001. Because Notice Review does not review 100 percent of the notices and refunds, these totals likely do not reflect all of the erroneous notices and refunds that should have been stopped.

In CY 2001, the Notice Review Program staff performed an analysis of the criteria used for the selection of notices to be reviewed in their program. However, it is important for the IRS to take additional steps to analyze notice error rates and identify error trends. In this way, the IRS could determine whether the errors were caused by systemic problems and, if so, what corrective actions could be taken.

The reliance on post-processing reviews to "catch" some of the erroneous notices and refunds before they are mailed to taxpayers is not an effective or efficient method to identify the root cause of a problem. Instead, once a systemic or procedural problem is identified, corrective actions should be taken to stop generating the erroneous notices and refunds.

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Similar to this, the General Accounting Office (GAO) recently issued a report⁵ to the U.S. Senate Committee on Small Business and Entrepreneurship regarding the analysis of data to prevent errors, which would reduce costs in time and money for both taxpayers and the IRS. The report recommended that the IRS evaluate the benefits and costs of collecting additional data on small business tax abatements to study cost-effective ways to reduce or eliminate the errors in tax assessments that have to be abated. The GAO recognized that collecting data such as why the error occurred, taxpayer burdens created, and IRS costs incurred, had the potential benefit of uncovering the root causes for errors that could guide the IRS to solutions that would help prevent the errors. The Commissioner, SB/SE Division has established a team to study the findings and any additional data developed by the IRS on this issue.

A national review and analysis of the notice error rates may identify problems requiring corrective actions

The Notice Review function managers at the IRS Campuses review notice error rates weekly to identify problem trends at the unit level. Reviews are performed of the function's work as a whole, rather than focusing on individual tax examiners who may only have one or two such cases in a batch of work. According to one Notice Review Program manager, the BMF trends have historically been more difficult to identify than the IMF trends because fewer BMF cases were reviewed by the Notice Review function.

Under the IRS' new business organization, BMF returns are beginning to be processed at only two sites.⁶ The resulting increase in BMF volume per site may facilitate identification of trends by the Cincinnati and Ogden Campuses' Notice Review functions, but a further analysis is often required to determine root causes.

⁵ *Tax Abatements: Better IRS Data Could Benefit Small Business and IRS* (GAO-02-336, dated January 2002).

⁶ BMF returns are beginning to be processed only at the IRS' Cincinnati and Ogden Campuses, excluding International returns which will be processed at the Philadelphia Campus.

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During our review, we found that problems identified in the Notice Review functions were errors (e.g., IRS data transcription, tax returns coding, or computation mistakes) that could be identified by comparing the actual returns to the notices or accounts, and the errors appeared on several returns. The Notice Review functions advised the appropriate processing areas and monitored the notice error rates for improvement.

However, there is no national trend analysis performed of the error rates reported by the Notice Review functions. Without such a broad analysis, the IRS cannot determine whether systemic problems are causing erroneous notices and/or refunds, and foregoes the opportunity to develop the process improvements called for by the IRS' Strategic Plan.

Example of the need for a national review and analysis of notice error rates to identify trends

A prior TIGTA report⁷ identified the root causes of systemic and procedural problems which could have been identified by the IRS had an analysis been performed at the national level. This report estimated that for Tax Years 1996, 1997, and 1998, \$1.4 billion in Gift Tax payments had been misapplied, and most requests for extensions to file the Gift Tax returns had not been processed to the taxpayers' Gift Tax accounts. The problems caused an estimated 18,357 incorrect notices and \$237 million in erroneous refunds to be sent to taxpayers. Numerous taxpayers were mistakenly charged approximately \$3.2 million in penalties, and the IRS had to pay some taxpayers an estimated \$8.1 million in interest for delayed refunds.

The Notice Review functions at the IRS Campuses had reviewed and corrected some of the erroneous notices and refunds for the affected accounts before they were sent to the taxpayers. However, not all the notices selected were reviewed, and not all the erroneous refunds could be stopped before being sent to taxpayers. The root causes of the problem were not obvious to the individual tax

⁷ *Significant Improvements are Needed In Processing Gift Tax Payments and Associated Extensions To File* (Reference Number 2000-30-154, dated September 2000).

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examiners or managers. For years, the IRS assumed the problem was caused by human error.

Inclusion of voided notices in PAS reviews may identify problems requiring corrective actions

The PAS Notice Review function performs an analysis based on a sampling of notices being sent to taxpayers. They provide feedback to the functions in Submission Processing, Accounts Management, or Compliance regarding errors and systemic problems.

The PAS selects two samples. One sample is selected from all notices, and the other from all notices selected for review by the Notice Review functions. One in 361 notices was selected for PAS Notice Review in CY 2001, but there was no concentration on notices with a history of high error rates. While the Internal Revenue Manual instructs the PAS reviewers to determine if the notice correctly reflects the state of the taxpayer's account, it also instructs them not to include voided notices in their sample.⁸ SB/SE and W&I Divisions' Customer Accounts Services' analysts have indicated that voided notices are not printed and cannot, therefore, be reviewed.

The Notice Quality measurement used by the PAS tracks the percentage of error-free notices sent to taxpayers. However, the Quality Review process is intended to provide a method to monitor, measure, and improve the quality of work by using Quality Review data to identify trends, problem areas, training needs, and opportunities for process improvement.

When voided notices are excluded from the PAS sample, these notices bypass measurement under the IRS' Balanced Measures of performance. In addition, the IRS runs the risk of not notifying taxpayers of pending IRS actions, or not notifying them in a timely fashion.⁹ The status of these

⁸ These accounts may be reviewed by the PAS analysts under another program if adjustments are made to the accounts.

⁹ Note: Under the IRS Restructuring and Reform Act of 1998 (P.L. 105-206), when an individual taxpayer is not timely issued a notice the penalty and interest may be suspended for that period of time until the notice is provided. Notices voided in error could result in the suspension of penalties and interest for these taxpayers.

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accounts should determine whether a notice should have been issued.

The 2 IRS Campuses transitioning to BMF submission processing voided 47,351 (17 percent) of 281,340 notices reviewed in CY 2000, and 57,710 (16 percent) of 371,702 notices reviewed in CY 2001.¹⁰ By not including voided notices in their sample, PAS analysts do not provide complete information to Headquarters analysts, thus reducing their opportunities to identify trends and systemic problems on both the local and national levels.

Recommendations

1. The Director, Customer Accounts Services, SB/SE Division, should ensure that notice error rates are reviewed at the national level so that notice error trends can be identified, analyses can be performed to determine whether the rates are due to systemic or procedural problems, and actions can be taken to resolve the identified problems.

Management's Response: IRS management has directed the PAS Units in the IRS centers that process business returns to perform a monthly analysis of the notice error rates to identify trends, determine root causes, and propose solutions. The results will be included in the Balanced Measures submitted to SB/SE Division Headquarters.

2. The Director, Customer Accounts Services, W&I Division, should ensure that the PAS Notice Review sample universe includes accounts where notices were voided by the Campuses' Notice Review functions, to ensure that taxpayers are receiving written notification when they should, and to take advantage of the opportunity to identify systemic or procedural errors and solutions at local or national levels. Since IRS' management has indicated that voided notices are not printed and cannot be reviewed, they should ensure that

¹⁰ The CY 2001 figures include notices reviewed through the 43rd week at the Cincinnati Campus and through the 40th week at the Ogden Campus.

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the related taxpayer accounts are identified so that PAS analysts can determine whether a notice should have been issued.

Management Response: IRS management will explore the feasibility of having the PAS Units conduct a review of voided notices on a 90-day test basis. The results will be submitted to SB/SE Division Headquarters for evaluation.

Detailed Objective, Scope, and Methodology

The overall objective of this audit was to determine if the Internal Revenue Service's (IRS) Notice Review function has been effective in identifying trends in erroneous refunds and notices for business taxpayers' accounts, in initiating corrective actions, and in determining additional steps that could be taken to make use of available information to identify systemic and procedural problems.

In order to accomplish our objective, we:

- I. Determined what measures the IRS took, or plans to take in the near future, to identify trends in erroneous refunds and notices.
 - A. Reviewed prior reports and studies on erroneous refunds and notices and determined if the IRS implemented, or plans to implement in the near future, recommended corrective actions.
 - B. Determined what, if any, analysis was performed.
 1. Reviewed Internal Revenue Manuals to determine what guidelines are available for review of erroneous refunds and notices.
 2. Obtained reports and data relating to notices and relevant statistics maintained on computer sites such as On Line Notice Review, Electronic Online Network System, and Quality Review Data Base.
 3. Interviewed managers and analysts in the IRS Brookhaven, Cincinnati, and Ogden Campuses' Notice Review functions to determine what trends were reviewed, what analysis was performed when error trends were identified to determine the root causes, and what procedures were in place to take action to correct problems identified.
 4. Interviewed the Problem Analysis System (PAS) Notice Review Coordinator for the IRS Brookhaven Campus to determine what trends were reviewed, what analysis was performed, and what procedures were in place to take action to correct problems identified.
 5. Interviewed analysts for the Small Business/Self-Employed (SB/SE) Division's Headquarters' Notice Review function to determine what trends were reviewed, what analysis was performed when error trends were identified to determine the root causes, and what procedures were in place to take action to correct problems identified.

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6. Interviewed PAS analysts for the SB/SE and Wage and Investment Divisions' Headquarters to determine what Notice Review trends were reviewed and why voided notices were not included in their sample.
 7. Determined whether any new initiatives had been developed due to the transition of Business Master File¹ processing to two processing sites.
- C. Based on all the above, determined if additional steps could be taken to make use of available information to identify systemic and procedural problems.

¹ The Master File is the IRS' main computer system. The Business Master File contains business taxpayer accounts.

Major Contributors to This Report

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Appendix III

Report Distribution List

Commissioner N:C
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Director, Customer Accounts Services, Small Business/Self-Employed Division S:CAS
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Appendix IV

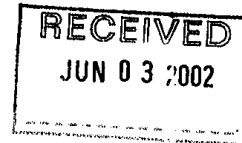
Management's Response to the Draft Report



SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

MAY 24 2002



**MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION**

FROM:

John Joseph G. Kehoe *John G. Kehoe*
Commissioner Small Business/Self-Employed Division

SUBJECT:

Draft Audit Report # 2001-30-049 titled, "Analysis of Notice Error Trends May Identify Systemic and Procedural Causes for Erroneous Notices and Refunds"

This response supersedes our reply of April 29, 2002 on your draft report titled, "Analysis of Notice Error Trends May Identify Systemic and Procedural Causes for Erroneous Notices and Refunds." We have reconsidered the issues raised and revised our response.

The accuracy of notices issued to taxpayers is of great importance to us. For this reason, we use a number of systems and procedures to ensure the accuracy of notices. Employees responsible for taking actions that generate notices are subject to individual quality review, to determine if their actions contributed to an erroneous notice in any way. The Output Review function at each Submission Processing Center reviews randomly selected notices (with the exception that we review the notices most likely to be in error more frequently).

Notice programmers also review notice programming to prevent errors, and the Systems Acceptability Testing (SAT) area staff tests their programs to ensure they work properly. Other subsystems are also in place to help ensure notice accuracy – for example, the Computer Assisted Review of ERS (CARE) system selects Error Resolution System (ERS) cases that will generate math error notices for review and correction prior to notice generation.

We have a Submission Processing Balanced Measure for Notice Error Rate. Analysts review notices for errors and report the results as part of our organizational performance measures. Throughout all of the systems in place to improve notice accuracy, the personnel that use these systems are encouraged to identify and report any systemic problems or error trends.

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Before I address the specific recommendations, one portion of this audit needs some clarification. The IRS Notice Review system selects notices for review based on the potential for the notice to contain erroneous elements. The notices reviewed are those most likely to contain an error, and therefore the statistics for reviewed notices (such as "...at least 32 percent of the BMF notices reviewed had to be corrected or voided...") do not necessarily represent the overall Notice Error Rate.

Our comments on the specific recommendations in this report are as follows:

RECOMMENDATION 1

The Director, Customer Accounts Services, SB/SE Division, should ensure that notice error rates are reviewed at the national level so that notice error trends can be identified, analyses can be performed to determine whether rates are due to systemic or procedural problems, and actions can be taken to resolve the identified problems.

ASSESSMENT OF CAUSE

SB/SE Headquarters staff does not conduct a formal analysis of Notice Review data.

CORRECTIVE ACTION

The PAS Units in the Cincinnati Submission Processing Center (CSPC) and the Ogden Submission Processing Center (OSPC) have been directed to conduct a regular monthly analysis of Notice Review data to determine notice error trends, identify root causes and propose solutions.

PROPOSED IMPLEMENTATION DATE

January 1, 2003

RESPONSIBLE MANAGEMENT OFFICIALS

Director, Small Business/Self-Employed Customer Account Services S:CAS:SP

CORRECTIVE ACTION MONITORING PLAN

CSPC and OSPC will submit the results of the new PAS analysis on Notice Review data to Headquarters on a monthly basis, as an addendum to the Notice Error Rate submission for the Balanced Measures report.

RECOMMENDATION 2

The Director, Customer Account Services, W&I Division, should ensure that the PAS Notice Review sample universe includes accounts where notices were voided by the

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Campuses' Notice Review functions, to ensure that taxpayers are receiving written notification when they should, and to take advantage of the opportunity to identify systemic or procedural errors and solutions at local or national levels. Since IRS' management has indicated that voided notices are not printed and cannot be reviewed, they should ensure that the related taxpayer accounts are identified so that PAS analysts can determine whether a notice should have been issued.

ASSESSMENT OF CAUSE

The primary purpose of the Notice Error Rate Measure is to target the largest volume of specific notices and review the quality of notices mailed to the taxpayers. The Accounts Management and Compliance Quality Review Program, IRM 21.10.1.5.3, provides procedures for sampling Notice Paper and within those procedures it states, "Do not sample voided cases."

CORRECTIVE ACTION

We generally agree with the intent of this recommendation and feel that there are systems in place, i. e., and formal quality review supplemented by managerial reviews, which substantially accomplish this. However, we will explore the feasibility of having the PAS Units conduct a review of voided notices on a test basis.

PROPOSED IMPLEMENTATION DATE

January 1, 2003

RESPONSIBLE MANAGEMENT OFFICIALS

Chief, Program Management/Process Assurance Branch
Director, Submission Processing, CAS (Wage and Investment Division)

CORRECTIVE ACTION MONITORING PLAN

The test will be performed for 90 days beginning January 1, 2003. The results will be submitted to Headquarters for evaluation.

If you have any questions about this response, please contact John A. Ressler, Director, Customer Account Services, Small Business/Self-Employed, at (859) 669-5557, or John R. Parker, Chief, SP Program Management Process Assurance, at (859) 669-5561.